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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

RE: PCAOB No. 2011-003, Rulemaking Docket No. 34 – Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards

Mssrs. Doty, Ferguson, Goelzer, Hanson, and Harris:

I commend the PCAOB for initiating its project on improvement of the auditor's reporting model. It's an effort worthy of the PCAOB's mission to strengthen the audit process for the benefit of investors. The current auditor's opinion, while concise, does not convey to investors any significant insights obtained by auditors during the audit process. Rather than perpetuating the audit reports investors rarely read, if ever, I think it is wise to consider if there are other ways the auditor can provide genuine value to the investor.

The chief information given to investors in the current auditor's opinion is that the financial statements are presented in accordance with generally accepted accounting principles. When you consider that there are thousands of pages of accounting standards, and often, alternative accounting treatments for one particular kind of transaction, the current auditor's opinion really says very little to the investor. It's even less information in comparison to the time spent on the job by the auditor and the kinds of insights the auditor should be obtaining.

Investors – the real client of the auditor, not the firm audited - depend on the auditor to be their “eyes, ears and nose” when they are inside the audited firm. Auditors executing their duties under PCAOB auditing standards should be aware of many more facts than are currently conveyed by the auditor's report, and if executed properly, these findings could help investors better understand the risks entailed in a particular investment, thereby enabling them to improve their investment decision-making.

Changes to the status quo will always make some parties uncomfortable. One defense of the status quo is likely to be that any modifications to the auditor's report will result in increased audit costs. If the information provided to investors is valuable, then investors – who are the ones actually bearing the costs of the audit - would be unlikely to complain about increases in audit fees. In fact, I have never encountered an investor who complained about the size of audit fees; if investors discuss audit fees at all, they might wonder sometimes how a legitimate audit was accomplished at such a low fee. Likewise, I have never encountered a company that blamed a poor earnings report on audit fees that were too high.

Auditing firms should be looking for ways to justify increases to their audit fees; putting more information into the auditor's report would be a good justification for increasing fees. It may sound odd to promote higher audit fees, but the audit profession needs to find auditing profitable in comparison to non-audit endeavors like consulting – or auditing will always be a second fiddle to more lucrative ventures, making it harder to attract and retain the most competent and motivated auditing talent. Investors do not benefit if auditing is a second-tier function in accounting firms, and improving communications to investors is an opportunity for audit firms to better their audit operations by improving the lot of investors.

Suggesting that audit fees should increase (as long as value is given for an increase) is not a glib proposition. Our firm has conducted a study of the audit fees, plus audit-related fees, for the 461 firms currently contained in the S&P 500 for which fee data is available for all of the years between 2002 and 2010. A summary compilation of audit and audit-related fees, by firm, appears at the top of the next page.

S&P 500 Audit Fees By Auditor

(\$ in millions)	2010	2009	2008	2007	2006	2005	2004	2003	2002
PricewaterhouseCoopers	\$1,659	\$1,665	\$1,582	\$1,551	\$1,517	\$1,482	\$1,468	\$997	\$795
Ernst & Young	934	920	940	912	874	776	698	525	481
Deloitte & Touche	914	905	979	1,003	961	886	756	489	432
KPMG	743	739	764	732	713	638	596	399	313
BDO Seidman	8	7	8	7	5	5	9	9	1
Grant Thornton	--	--	--	--	--	--	1	1	1
Arthur Andersen	--	--	--	--	--	--	--	--	2
	\$4,258	\$4,236	\$4,273	\$4,205	\$4,070	\$3,787	\$3,528	\$2,420	\$2,025
Annual % change:	0.5%	-0.9%	1.6%	3.3%	7.5%	7.3%	45.8%	19.5%	
Total change: 2002 - 2006	101.0%								
Total change: 2006 - 2010	4.6%								

Table was constructed from the audit fees and audit-related fees listed in the proxies for 461 S&P 500 companies operating as separate independent entities for the entire period.

Notice that audit and audit-related fees doubled between 2002 and 2006, due to the implementation of the Sarbanes-Oxley Act. From 2006 to 2010, however, audit and audit-related fees remained essentially flat, not even keeping pace with inflation – and this period encompasses the financial crisis, a period in which auditors would be expected to spend more time and effort in discharging their duties. One wonders if firms were able to keep audit performance high during this period: auditors’ risk levels certainly didn’t decrease, and investors would have to hope that they were spending the proper amount of time in conducting fieldwork. Did audit firms keep hours spent on fieldwork and audit quality high, and suffer their own decreased financial performance? Or did they cut corners on hours spent on fieldwork while preserving their own profitability? It’s hard to tell because the audit firms do not present any of their own financial information to the public, but it’s clear that in the long run, investors can’t expect audit fees to stay low forever if they expect to benefit from high audit quality.

I hope all audit firms, both large and small, will support the concept release and work toward serving their investor clients better by trying to foment some of the suggested changes. The following is an expansion of the four proposed changes from the investor’s point of view.

Auditor’s Discussion and Analysis (AD&A). I believe the Auditor’s Discussion & Analysis is the single best proposal in the concept release. Properly prepared as a supplemental report, this document would be the best means for auditors to communicate to investors as their agent inside the investee firm.

According to Auditing Standard No. 9, the planning of an audit requires the auditor to consider:

- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company’s business, including its organization, operating characteristics, and capital structure;
- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company’s internal control over financial reporting;
- Knowledge about risks related to the company evaluated as part of the auditor’s client acceptance and retention evaluation; and
- The relative complexity of the company’s operations.

During this planning process, the auditor should become aware of circumstances, both inside and outside of the firm, that will have an impact on the conduct of the audit. Those circumstances and/or risks would make an excellent discussion topic for the Auditor’s Discussion & Analysis. They could include an identification of the factors that the auditor considered most important in planning the audit, and how the identified factors affected the allocation of auditor resources in conducting the audit. The factors that would affect the way an auditor thinks about risks of material misstatement of financial information might also affect the way that an investor views risks of an investment in the firm – if the risks were communicated to investors. I believe that many investors don’t always adequately consider investment risks as much as they consider investment rewards. Adding more information about risks from another point of view – one coming from an advocate of the investor – might help some investors change their thinking before investing.

The AD&A could also be integrated with the “Risk Factors” section appearing in SEC filings. These are often useful to investors, but are also frequently so comprehensive that they seem to be developed as a sort of prophylaxis against legal liability, as if warning investors about any possible downside will neutralize a potential lawsuit. If the AD&A presents an informative discussion of the risks observed by the auditor from the inside of the firm, it could perhaps replace some of the boilerplate risk factors. Another possibility: the AD&A could be used to explain how the auditor evaluated the risk factors in formulating its audit plan.

A discussion of circumstances, risks, and how the auditor managed them would provide a context for investors that they don't currently receive in the financial statement package. It might make the AD&A a more engaging document for investors than the Management's Discussion & Analysis; it could certainly provide a contrast in the points of view provided by those who manage a firm and by those who examine the firm for the benefit of its owners.

The AD&A should also speak to the critical accounting policies and estimates appearing in the Management's Discussion & Analysis. These policies and estimates should have the auditor's attention in assessing risks and planning the audit. Investors would benefit from understanding the auditor's view on their significance and how they affected the conduct of the audit. They would also benefit from knowing if there were critical accounting policies and estimates that didn't appear in the Management's Discussion & Analysis that the auditor believes should have been included.

I do not believe that the AD&A should be a forum where the auditor is required annually to disclose disagreements with the management on issues that have been resolved to the auditor's satisfaction, as evidenced by the auditor's clean opinion. At the same time, the auditor should have the right to present their point of view in the AD&A when they believe the firm has employed accounting principles that fulfill the letter of the law but stray from the spirit of the law. Put another way, when the firm has engaged in “cute” or “clever” accounting that complies with GAAP but presents an unrealistic picture of performance of financial status, the auditor should be able to call out this behavior in the AD&A. Having that option available to the auditor might actually deter “clever” accounting practices in some companies.

An example of “cute” accounting: under U.S. GAAP, firms are required to disclose in the financial statement footnotes, on a quarterly basis, the fair value of financial instruments. In the Accounting Standards Codification, there exists an example of such disclosures for originated loans, but the example incorporates a pre-Statement 157 concept of fair value – one that is not based on exit values, and is therefore not in conformity with the current standard. It exists in the codification erroneously. Yet firms will use that erroneous example as a template for their own disclosures, and they can claim conformity with GAAP. Auditor discussion of this treatment would be appreciated by investors – if it ever appeared in an AD&A.

The AD&A should not be a document that's forced into a prefabricated mold. It should be primarily a text document, similar to the Management's Discussion & Analysis, and one that's flexible and adaptable to the situations encountered by the auditor. It could be based on the same information, albeit more highly summarized, that the auditors provide to a firm's audit committee.

The current auditor's report creates distance between the auditor and the party they are hired to serve – the investors. Being a standard formatted document, with only a black-and-white meaning, it does not effectively communicate the auditor's insights to the investors. The Auditor's Discussion & Analysis could go far beyond that binary “pass/fail” mentality; it could be a device that helps bridge the gap between auditors and investors. It would not have to be a document that will add hundreds of hours to an engagement: rather than requiring new or additional audit procedures, it would be more of an abstract and compendium of plans, communications and memos that are already compiled during the audit engagement.

There is the possibility that the AD&A could become a lame boilerplate document, year after year. The responsibility for seeing that this doesn't happen rests with the PCAOB. Inspections of the work papers on audit engagements give the PCAOB access to the same kinds of documents that should be the foundation for a well-written AD&A; the PCAOB inspectors should be able to make judgments as to whether reasonable attempts have been made to communicate relevant information to investors about the audit. Keeping the AD&A a focus of the inspection process will keep auditors vigilant in their development of the AD&A.

If presented as a supplement to the basic auditor's report, I believe that the Auditor's Discussion & Analysis would be unparalleled in bringing investors more useful information about the audit.

Required and expanded use of emphasis paragraphs. Relative to a required AD&A, I would consider required and expanded use of emphasis paragraphs to be a poor second choice for improving communications between auditors and investors. In theory, the same kind of information might be conveyed in emphasis paragraphs as in the AD&A, but I think it would be far less effective. The AD&A would be a more flexible document, one that could be lengthier than a paragraph on a particular topic. I believe that a requirement to use emphasis paragraphs would be far more likely to result in over-abbreviated information, and would be far more prone to becoming boilerplate talking points than would a full-fledged AD&A.

Auditor Assurance on Other Information Outside the Financial Statements. This is perhaps the most far-reaching alternative presented in the concept release, but it would provide less benefit to investors than the AD&A. I have not encountered investors who lament the lack of auditor assurance on the Management's Discussion & Analysis, or non-GAAP information, or earnings releases. They might want more or different non-GAAP information, more information drawn from the financial statements incorporated into earnings releases, or earlier earnings releases. I think if you were to poll a wide range of institutional investors, you would hear many ideas for improving non-financial statement information, but I believe all suggestions would relate to information content or timing.

It's hard to see enough benefit resulting from this approach to justify the time and expense of developing new auditing standard for this kind of work. This simply does not seem to provide a more effective means of improving communications between auditors and investors than an AD&A.

Clarification of language in the standard auditor's report. The concept release suggested these possible clarifications of the auditor's report:

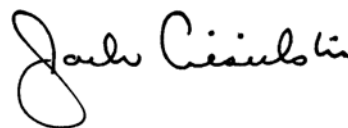
- Reasonable assurance
- Auditor's responsibility for fraud
- Auditor's responsibility for financial statement disclosures
- Management's responsibility for the preparation of the financial statements
- Auditor's responsibility for information outside the financial statements
- Auditor independence

I endorse all of these proposed changes to the auditor's report. Investors should understand the concept of reasonable, not absolute, assurance and the role it plays in conduct and completion of an audit. At the same time, the auditor's opinion should inform investors that the auditor has a responsibility to determine that the financial statements are not materially misstated by either fraud or error. Furthermore, auditors have always applied audit procedures to financial statement disclosures, yet their opinion does not currently speak to disclosures. There is no reason to exclude the auditor's responsibility for disclosures from the auditor's report. Because the responsibility for the preparation actually resides with management, the auditor's report should make that clear, as well as defining the responsibility of the auditor for information outside of the financial statements. Finally, the current audit report barely speaks to the independence of the auditor. A stronger statement as to the auditor's independence would both be informative for investors and a reminder to auditors of their obligation to be independent of the audited firm.

All of the proposed changes to the standard auditor's report are of a clarifying nature: they define more clearly the nature of an audit, an auditor's responsibilities to its investor clients, and the nature of management's responsibilities. Because they educate investors about the audit process and the fences around the different parties' responsibilities, they also provide incremental value to the communications between auditor and investors. I see no harm in incorporating them into the standard auditor's report.

Those are my formal comments on the concept release. If I can provide any clarification or amplification, please do not hesitate to contact me. Best regards.

Sincerely,



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